CPE Article

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Compensation Earn-Outs and Post Business Combination Earning Surprises

Compensation earn-outs (earn-outs) are contingent post business acquisition expenses in the form of liabilities or equity. The acquirer promises to grant certain awards in a form of cash or equity to certain employees of the acquired entity if they achieve certain performance objectives or if certain conditions are met during the post-acquisition period. Like other forms of contingencies, earn-outs must be measured at fair value at the time of acquisition and be included in the post business combination earnings of the acquirer. It is a misconception that they should be accounted for as part of goodwill in purchase accounting.

CPE Self Study

Curriculum: Accounting and Auditing
Level: Intermediate
Designed For: CPAs in publicly held corporations or public practice
Objectives: To clarify and explain the U.S. GAAP guidance regarding the treatment of compensation earn-outs in post-business combinations
Key Topics: Earn-outs, stock compensation, contingencies, commitments, and business combinations
Prerequisites: None
Advanced Preparation: None

For example, Entity A acquires Entity S and promises certain executives of Entity S that if they remain with the company during the post-acquisition for a certain period of time and if the acquired product line of Entity S generates a certain level of revenues during this period, they will receive some cash bonuses. In this example, Entity A recognizes contingent consideration liability and an expense during the post-business combination period.

If the earn-out provision requires issuance of equity awards instead of cash payments, the earn-out contingency may be recorded in equity rather than liabilities. There are instances, however, when equity awards may be recorded as liabilities, as discussed later in this article.

This article will address various types of earn-outs and their impact on the financial statements of the acquirer. There are certain types of earn-outs – in particular, equity awards classified as liabilities – that may impact the earnings of the acquirer based on certain circumstances that may not be completely under management's control. The discussion is followed by a detailed

illustration reflecting the nuances related to earn-out accounting. The earn-out accounting guidance impacts the acquirer's acquisition accounting and introduces a level of volatility in the acquirer's earnings during the post-business combination periods.

TYPES OF EARN-OUTS

Earn-outs are usually conditioned based on service, performance or market conditions:

- A service condition simply stipulates that an employee must remain employed during the earn-out period to be eligible to receive the bonus.
- A performance condition, on the other hand, usually targets achievement of certain company internal operational metrics during the earn-out period for eligibility.
- A market condition, by contrast, ties the vesting or payout to either an absolute or relative stock price hurdle during or at the end of the earn-out period.

Therefore, service condition results in explicit service period, whereas performance and market conditions result in implicit and derived service periods, respectively.

Earn-outs at the time of acquisition are classified as either liabilities or equity:

- In liability-classified earn-outs, the acquirer is obligated to pay cash or transfer other assets to the acquiree.
- In equity-classified awards, the acquirer is required to issue its shares to the acquiree. However, the requirement to issue shares may not always result in equity classification.

CONTINGENCIES

Contingency losses are conditions, situations or sets of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

The initial classification of earn-outs may significantly impact the acquirer's post-business combination earnings. Contingent considerations classified as liabilities are measured initially and subsequently at each reporting date at fair value. Any changes in the fair value of contingent consideration in the form of liabilities are recognized in earnings until the contingent consideration arrangement is settled. The contingent awards in the form of equity, on the other hand, if classified as equity are not required to be re-measured at the end of each period.

Cash or equity earn-outs are not pre-acquisition contingencies and are not within the scope of Accounting Standards Codification (ASC) 805, *Business Combinations*, but rather are both subject to ASC 450, *Contingencies* [f/k/a Financial Accounting Standards Board (FASB) Statement No. 5]. As a result, the acquirer does not recognize earn-out expenses as part of purchase accounting in goodwill.

When a loss contingency exists as a result of earn-out arrangements, the likelihood of its incurrence can range from probable (the future event or events are likely to occur) to remote (the chance of the future event or events occurring is slight). The Contingencies Topic (ASC 450) uses the terms *probable, reasonably possible* (the chance of the future event or events occurring is more than remote but less than likely), and *remote*, to identify three areas within that range (ASC 450-20-25-1).

An entity should estimate the loss from a loss contingency and accrue it by a charge to earnings if both of the following conditions are met (ASC 450-20-25-2):

- It is probable that a liability had been incurred at the date of the financial statements.
- The amount of loss can be reasonably estimated.

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EXHIBIT 1

	BEG. OF THE 1ST QUARTER	1ST QUARTER	2ND QUARTER	3RD QUARTER	4TH QUARTER
FORFEITURE RATE (*)	—	20%	20%	20%	20%
ACQUIRED PRODUCT LINE QUARTERLY REVENUE	—	$250,000	$200,000	$500,000	300,000
PROBABILITY OF ACHIEVING $1.2 MM REVENUE	—	NOT PROBABLE	NOT PROBABLE	PROBABLE	ACHIEVED
PROBABILITY OF ACHIEVING $1.5 MM REVENUE	—	NOT PROBABLE	NOT PROBABLE	PROBABLE	NOT ACHIEVED
STOCK PRICE	$16.00	$17.00	$18.00	$15.00	$20.00
MARKET CONDITION $30 STOCK PRICE TARGET		NOT PROBABLE	NOT PROBABLE	NOT PROBABLE	NOT ACHIEVED
FUTURE CRUDE OIL PRICES INCREASE (DECREASE)	—	0.1%	(8.5%)	(10.1%)	(8.1%)
OIL PRICES NOT TO EXCEED BY MORE THAN 20%		PROBABLE	PROBABLE	PROBABLE	ACHIEVED
BLACK-SCHOLES-MERTON VALUATION	$6.00	—	—	—	—
LATTICE METHOD VALUATION	$5.00	—	—	—	—
MONTE CARLO VALUATION	$5.00	$5.00	$5.00	$6.00	$7.00

(*) ENTITY A ESTIMATED AT THE TIME OF ACQUISITION THAT ONE OUT OF THE FIVE EXECUTIVES OF ENTITY S WILL BE TERMINATED DURING THE EARN-OUT PERIOD. DURING THE FOURTH QUARTER SUBSEQUENT TO ACQUISITION, ONE OF THE EXECUTIVES OF ENTITY S LEAVES THE COMPANY BUT THE REMAINING FOUR EXECUTIVES WILL CONTINUE THEIR SERVICES THROUGH THE END OF THE EARN-OUT PERIOD.

If an amount within a range of loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will ultimately be determined, it is not likely that the ultimate loss will be less than the minimum amount (ASC 450-20-30-1).

After the date of an entity's financial statements but before those financial statements are issued or are available to be issued, information may become available indicating that an additional or lower amount of cash earn-outs should have been accrued. If so, disclosure may be deemed necessary to keep the financial statements from being misleading. The disclosure should include the following (ASC 450-20-50-9):

- The nature of the earn-outs adjustment.
- An estimate of the amount or range of adjustment.

CASH EARN-OUTS

Accounting for cash earn-outs is relatively simple. They are classified as liabilities in the balance sheet and their fair values are re-measured periodically and the changes are reflected in earnings. The forfeiture estimate of the cash awards impacts the amount of accrual for cash earn-outs at the end of each period. Cash earn-outs can be either service based or performance and market based. If material and the timing and amounts of future cash flows are fixed or reliably determinable (ASC 835-30, *Interest – Imputation of Interest*), the time value of the projected payouts for the cash earn-outs must be taken into account. Changes in estimate of future cash earn-outs are reflected in earnings periodically and the offsetting account is usually accounts payable accruals.

EQUITY EARN-OUTS CLASSIFIED AS EQUITY

A complete and comprehensive discussion of equity awards is beyond the scope of this article. Generally, equity awards for equity earn-outs have either a requisite service period or are subject to performance and market conditions. A performance condition ties an equity award to a certain performance and operational target, whereas market condition ties the awards to certain stock price hurdle.

Therefore, equity-classified awards granted under ASC 718, *Stock Compensation*, should contain one of the following conditions, as well as certain other requirements:

- a market condition,
- a performance condition,
- a service condition.

Valuation and expense amortization of an equity award is based on type, terms and conditions of the awards. If an equity award is indexed to a factor other than market, performance or service conditions, the award should be classified as liabilities.

Companies usually use Black-Scholes-Merton or lattice (binomial) models for valuation of stock options with service

conditions. Market and performance based awards, however, may require use of lattice or Monte Carlo valuation techniques. For example, for a market condition, the Monte Carlo valuation model simulates stock prices into the future and on different potential paths (thousands and thousands) of the stock price. Then, the fair value of the instrument is computed by averaging all these paths values.

An entity should recognize the fair value of stock compensation in its financial statements over the requisite service period through a charge to compensation cost and a corresponding credit to equity [additional paid-in capital (APIC)] or to liabilities, depending on the classification of the award. It should also be noted that equity awards not only impact the compensation costs but also earnings per share (EPS) and the deferred tax assets (DTA).

Performance or market conditions per se do not impact the valuation of equity awards, but rather it is the forfeiture rate estimates that determine the percentage of accrual costs for service and performance or market based equity awards. In fact, performance and market conditions must be viewed as a "special type" of service condition. Therefore, forfeiture rate estimates function similarly for service condition awards as well as for performance and market condition awards.

EQUITY EARN-OUTS CLASSIFIED AS LIABILITIES

ASC 718-10-25-6 through 25-19 determine whether an equity award should be classified as liabilities or equity. ASC 718 describes five types of awards that should be classified as liabilities, although certain exceptions exist.

1. An award with conditions or other features that are indexed to something other than a market, performance or service condition. (This article will illustrate the accounting treatment of this type of award.)
2. An award that meets certain criteria of ASC 480, *Distinguishing Liabilities from Equity*.
3. A share award with a repurchase feature that permits an employee to avoid the risks and rewards that are normally associated with stock ownership, or a share award where it is probable that the employer would prevent the employee from bearing the risks and rewards that are normally associated with stock ownership. These provisions are applicable for a reasonable period (at least six months) after the stock issuance.
4. An option or similar instrument that could require the employer to pay an employee cash or other assets in lieu of an option or similar instrument, unless cash settlement is based on a contingent event that is (a) not probable and (b) outside the control of the employee.
5. An option or similar instrument where the underlying stock is classified as a liability.

The most significant way that liability-classified awards differ from equity-classified awards is that liability-classified awards are re-measured each reporting period at fair value and the result is reflected in earnings. This feature of the liability-classified awards may create earnings volatility for the acquirer during the post-business combination periods.

The accounting treatment of liability-classified awards is as follows:

- Measure the fair value of the award on the grant date and recognize it as compensation.
- Re-measure the fair value of the award each reporting period until the award is fully vested.
- True up the compensation cost in each reporting period for changes in the fair value and pro-rate for the portion of the requisite service period that service is rendered.
- Recognize any additional changes in fair value upon vesting.

ILLUSTRATION

Entity A acquires Entity S in a business combination at the beginning of the first quarter. Entity A would like to retain the five top executives of Entity S for a period of at least one year. To entice the executives to continue their employment at Entity A, the company decides to offer them the following earn-out package:

1. Service cash earn-out – Executives will receive a cash bonus of $1,000 if they remain employed one year from the date of acquisition.
2. Performance cash earn-out – Executives will also receive a performance cash bonus of $1,000 if the revenue from the acquired product line exceeds $1.2 million during the first year subsequent to acquisition. The amount of bonus will not be less than $100 even if the goal is not achieved as long as the executives remain employed one year from the date of acquisition.
3. Service equity earn-out – Executives will receive a grant for 1,000 non-qualified stock options at an exercise price of $16 (the fair market value of the stock at the time of grant). The options will be fully vested upon completion of a year service subsequent to acquisition.
4. Performance equity earn-out (classified as equity) – Executives will receive a grant for 1,000 restricted stock units (RSUs) at an exercise price of $16 (the fair market value of the stock at the time of grant). The RSUs will be fully vested if the revenue from the acquired product line exceeds $1.5 million during the first year subsequent to acquisition.
5. Market condition equity earn-out (classified as equity) – Executives will receive a grant for 1,000 non-qualified stock options at an exercise price of $16 (the fair market value of the stock at the time of grant) if the price of Entity A stock exceeds $30 at the end of the first year subsequent to acquisition.
6. Other condition equity earn-out (classified as liability) – Executives will receive a grant for 1,000 non-qualified stock options at an exercise price of $16 (the fair market value of the stock at the time of grant), which will be fully vested if the percentage of increase in crude oil prices during the first year subsequent to acquisition does not exceed by more than 20 percent.

All cash bonuses and equity awards will be payable to the five executives of Entity S on an equal basis.

Exhibit 1 reflects the assumptions used in the above examples. Entity A estimated that one of the executives of Entity S would terminate his services during the earn-out period. During the fourth quarter of the earn-out period, one of the five executives actually left Entity A, and as a result the

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EXHIBIT 2

	1ST QUARTER	2ND QUARTER	3RD QUARTER	4TH QUARTER(*)	TOTAL	ACCOUNT
(1) SERVICE CASH EARN-OUT	$200	$200	$200	$200	$800	LIABILITIES (7)
(2) PERFORMANCE CASH EARN-OUT	$20	$20	$560	$200	$800	LIABILITIES (7)
(3) SERVICE EQUITY EARN-OUT	$1,200	$1,200	$1,200	$1,200	$4,800	EQUITY (APIC)
(4) PERFORMANCE EQUITY EARN-OUT	$0	$0	$9,600	($9,600)	$0	EQUITY (APIC)
(5) MARKET CONDITION $30 STOCK PRICE	$0	$0	$0	$0	$0	EQUITY (APIC)
(6) OTHER CONDITION CRUDE OIL PRICE	$1,000	$1,000	$1,600	$2,000	$5,600	LIABILITIES (8)

(1) $1,000 bonus less 20 percent forfeiture estimate = $800. There is no requirement for cumulative catch-up adjustment at the end of the earn-out period.
(2) Entity A accrues the minimum amount for the first and second quarters ($100 less 20 percent forfeiture rate = $80). The $800 performance bonus ($1,000 less 20 percent expected forfeiture rate) was not probable in the first and second quarters but became probable in the third quarter and as a result, Entity A made a cumulative catch-up adjustment for the first two quarters of $360 ($400 less $40 prior quarters accrual) plus the third quarter bonus of $200 = $560.
(3) 1,000 options less 20 percent forfeiture estimate times $6 (Black-Scholes-Merton value) = $4,800. The valuation occurs at the beginning of the period and is ratably amortized for four quarters. The valuation does not change or gets adjusted in each period.
(4) $1000 RSUs less 20 percent forfeiture rate at $16 = $12,800. The performance bonus was not probable in the first and second quarters, but became probable in the third quarter. Therefore, there is a cumulative adjustment $6,400 in the third quarter plus $3,200 quarterly charge. The whole amount will get reversed in the fourth quarter since the performance condition was not achieved.
(5) Entity A uses Monte Carlo simulation for valuation of these options but does not consider the vesting of options probable at any time; therefore, no accrual is required at the end of the different earn-out periods.
(6) 1,000 options less 20 percent forfeiture estimate times the corresponding Monte Carlo valuation in each period. The expense is trued up at the end of third and fourth quarters due to different valuations. In this example, the liability is measured at fair value at the end of each period (unlike examples 3 and 4 where the fair value measurement occurs only at grant date).
(7) These amounts will be offset against cash at the end of the period.
(8) This amount will be offset against equity (APIC) at the end of the period.

(*) Since one of the executives of Entity S is terminated during the fourth quarter, no cumulative adjustment for forfeiture true up is required in this period.

estimated forfeiture reserve is the same as the actual forfeited amount and no cumulative catch-up adjustment is required for forfeiture true up.

Exhibit 2 reflects the calculation of accrual in each period and the corresponding classification of earn-outs into either equity or liabilities.

CLOSE ANALYSIS REQUIRED

Earn-outs during the post-business combination are very common and the acquirer often uses them to entice the key employees of the acquired company to continue their services during the transition period. These earn-outs are not reflected in goodwill as part of an acquisition but are considered post-acquisition expenses. Therefore, they are not subject to ASC 805, *Business Combinations*, but rather they are covered under ASC 405, *Contingencies*, and ASC 718, *Stock Compensation*.

Management exercises significant judgment in determining the probability of these payments and their applicable forfeiture rates. Earn-outs could be in the form of cash or equity awards. The classification of equity awards in the form of equity or liabilities and the valuation of such awards also require exercise of significant management judgment and estimates.

Earn-out arrangements in an acquisition require close analysis. Determining the fair value of the equity awards at the outset is very important and could be challenging. Regularly updating the fair value of earn-outs classified as liabilities could result in earnings surprises during the post-business combination periods. Strategic navigation of the acquisition through the accounting requirements to obtain equity treatment for earn-outs can be difficult. Acquirers who do not focus on these matters when negotiating the terms and conditions of an acquisition may be surprised by the impact of earn-outs on their financial reporting, and the unintended financial volatility during the post-business combination periods. ■

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PARTICIPATION EVALUATION

(Please check one.) 5=excellent 4=good 3=average 2=below average 1=poor

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1 Compensation earn-outs are contingent post-business acquisition expenses that are reflected:

A. in goodwill.
B. in the acquiree's financial statements prior to business combination.
C. in the acquirer's financial statements post-business combination.
D. none of the above.

2 Earn-outs can be in the form of equity only.

A. True
B. False

3 Equity earn-outs are reflected in:

A. equity.
B. liability.
C. either equity or liability.
D. goodwill.

4 Earn-outs are conditioned based on:

A. service.
B. performance.
C. market.
D. all of the above.

5 Cash or equity earn-outs are:

A. pre-acquisition contingencies.
B. post-acquisition contingencies.
C. not contingencies.
D. partially pre-acquisition contingencies.

6 Cash earn-outs are classified as:

A. liabilities.
B. equity.
C. goodwill.
D. prepayments.

7 A loss contingency must get reflected in financial statements if:

A. it is probable.
B. it is estimable.
C. it is both probable and estimable.
D. it is reasonable.

8 An equity award should have one of the following conditions, as well as certain other requirements:

A. service
B. market
C. performance
D. all of the above

9 Companies usually use Black-Scholes-Merton or lattice (binomial) models for valuation of stock options with ________ conditions.

A. service
B. market
C. performance
D. performance or market

10 The liability awards granted as part of the earn-outs must be re-measured periodically and the changes in their fair values should be reflected in the statement of operations or income.

A. True
B. False